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Testimony of Gerald W. Padwe vice president - Taxation of the American Institute of Certified Public Accountants

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United States. Congress. House. Subcommittee on Select Revenue Measures

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TESTIMONY OF GERALD W. PADWE
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SUBCOMMITTEE ON SELECT REVENUE MEASURES
COMMITTEE ON HOUSE WAYS AND MEANS
HEARING ON MISCELLANEOUS REVENUE ISSUES

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INTRODUCTION

Good morning. I am Gerald W. Padwe, Vice President—Taxation of the 320,000-member American Institute of Certified Public Accountants. Accompanying me today is the chairman of the AICPA S Corporation Taxation Committee, Mr. Samuel P. Starr.

We thank you for the opportunity to testify on a tax issue of high priority for the AICPA, the reform of Subchapter S. We especially want to thank Representative Cardin for proposing these suggested amendments to subchapter S for the consideration of this subcommittee. We further want to recognize Representative Payne for the interest he has shown in our effort to modernize this area of the Internal Revenue Code.

Subchapter S was first enacted in 1958 to help remove tax considerations from small business owners' decisions to incorporate. Electing "subchapter S corporations" (as they were then called) were not subject to the classic two-tier tax system, applicable to nonelecting corporations. This tax treatment was helpful to small business and especially to start-up businesses. But subchapter S, as originally enacted, was very limiting and contained a number of pitfalls and traps for the unwary.

It was not until 1982 that subchapter S became popular. In that year, after a multi-year, collegial effort on the part of the AICPA, members of the American Bar Association's Section of Taxation, and the staff of the Joint Committee on Taxation, subchapter S was substantially revised to remove many of its traps and some of its obsolete restrictions. Subsequently, changes made in the *Tax Reform Act of 1986* made the election of subchapter S treatment highly desirable to many small businesses. Today, over 1.5 million small businesses, 42 percent of corporate tax return filers, are S corporations.[1] In short, the tax system and the small business community have both been beneficiaries of these efforts.

We come to you now, eleven years after the enactment of the *Subchapter S Revision Act of 1982*, asking that you modernize subchapter S to enable S corporations to operate more on a par with partnerships and C corporations (those corporations without a subchapter S election in effect). Our colleagues in this effort include the U.S. Chamber of Commerce and, again, members of the American Bar Association's Section of Taxation. In addition, a number of other organizations have been supportive of our efforts to modernize subchapter S, including the National Federation of Independent Business, the National Association of Private Enterprise, and the Small Business Legislative Council.

We believe subchapter S should be amended to better reflect the way small business does business in the '90s. Many of the prohibitive restraints currently in subchapter S date back to its original enactment in 1958. The financial environment in the 1990's is far more complex, and 1950's legislative restraints are handicapping small business. A 90's small business does not operate the way a 50's small business did. Times (and financial transactions) were simpler then. Subchapter S requires a fresh 90's outlook.

For instance, with the traditional sources of debt financing—commercial banks—presently restricting their loans to small business, these businesses have had to turn to nontraditional sources of financing such as venture capitalists and pension funds. Typically, these sources of financing want either an equity stake in the business or, at a minimum, debt that can be converted into equity interests. A small business operating as a partnership or C corporation can offer these benefits to a financier and thereby utilize these sources of capital. An S corporation cannot offer a similar set of inducements to financiers. Restrictions in subchapter S limit or outright preclude tapping these sources of financing.

The proposal to amend subchapter S which we are discussing today contains twenty-six separate recommendations. A number are contained in H.R.13, the *Tax Simplification Act of 1993*, which was introduced earlier this year by Chairman Rostenkowski. The package of recommendations, taken as a whole, would modernize this area of the Internal Revenue Code by accomplishing four broad goals:

- Reform of S corporation fringe benefit rules,
- Expansion of the capital formation techniques available to S corporations,
- Preservation of family-owned businesses, and
- Removal of undesirable tax traps.

REFORM S CORPORATION FRINGE BENEFIT TREATMENT

Place S corporation shareholders in the same position as owners of regular corporations with respect to fringe benefits. *Pamphlet,*[2] *section D.4.g.*

Under current law, an S corporation, unlike a C corporation, is not permitted to provide shareholder-employees with certain tax-favored fringe benefits. Instead, for fringe benefits purposes, the S corporation is treated as a partnership and 2-percent shareholders are treated as partners. All other shareholder-employees of the S corporation are treated like employees of a regular corporation with respect to fringe benefits.

The problem here is that S corporations operate at a disadvantage to C corporations with respect to fringe benefits paid to owner/employees. For owners of small businesses this is especially onerous because their fringe benefits are a greater portion of their overall compensation. Furthermore, owners of S corporations (like owners of partnerships and C corporations) are already governed by extensive antidiscrimination rules which make section 1372 treatment unnecessary.

> Example: All the employees of a small retail store (including the owners) receive medical and group-term life insurance coverage. As a C corporation, these benefits are tax-free to all employees including the owners. However, if this corporation elects S status, the benefits will be taxable to the owners.

To solve this problem, we recommend you repeal Code section 1372.

Repeal restrictions on qualified plan loans made to S corporation shareholders. *Pamphlet, section D.4.g.*

Under current law, a loan by a corporation's qualified retirement plan to a "disqualified person" is a prohibited transaction, subjecting the borrower to a penalty tax. For C corporations, a disqualified person includes any shareholder who owns ten percent or more of the corporation's stock. For an S corporation, however, any shareholder who owns *five percent* or more of the corporation's stock is a disqualified person.

The problem here is that when a C corporation makes an S election, any shareholder who owns between five and ten percent of the qualified retirement plan's corporate sponsor corporation must repay the loan before the effective date of the S election or face an automatic penalty tax. As a practical matter, very few people are aware that the restrictions on loans from qualified retirement plans are more stringent for an S corporation than for a C corporation. Consequently, five-to-ten-percent shareholders of a C corporation that elects S status may inadvertently find themselves subject to a penalty tax for failing to repay loans from qualified plans before the effective date of the S election.

> Example: A small software development company operates as a C corporation and maintains a qualified pension plan for its employees. An employee who also owns 6 percent of the corporation's stock borrows $10,000 from the plan to pay for a family medical emergency. The corporation elects to be an S corporation. The borrower/shareholder is unaware of the more restrictive limitation on plan loans to S corporation shareholder/employees and fails to fully repay the loan before the S election takes effect. She becomes subject to the automatic penalty.

We view this as a trap for the unwary, and recommend hat the current, more restrictive limitation on S corporation shareholders be repealed. The definition of a "disqualified person", as including a ten-percent-or-greater shareholder, should apply uniformly to both C corporations and S corporations.

ACCELERATE CAPITAL FORMATION

Increase the thirty-five-shareholder limitation to fifty shareholders. *Pamphlet, section D.4.a.1.*

Under current law, an S corporation election is not valid if the business has more than 35 shareholders. This presents a problem for multi-generational, family-held businesses. This highly artificial limit on the number of shareholders prevents a corporation from continuing to operate as an S corporation as the number of shareholding generations increases. Also, some high-tech corporations that want to reward key employees are artificially limited to a thirty-five shareholder limitation.

> Example: A furniture manufacturing company now owned by the second and third generations of the two founding families is an S corporation. Currently they have 25

shareholders. Mathematically, the S corporation status will not be able to continue into the next generation.

We recommend the current S corporation limit of 35 shareholders, which serves to restrict capital formation opportunities of smaller firms, be raised to 50 shareholders.[3]

Permit certain tax-exempt organizations to be eligible shareholders. *Pamphlet, section D.4.a.2.*

Under current law, a tax-exempt organization is not an eligible shareholder for purposes of a valid S corporation election. This presents a problem because tax-exempt organizations including pension plans, ESOPs (a qualified employee stock ownership plan), and university endowment funds are significant sources of capital for small closely-held businesses seeking to expand their operations. Because tax-exempt organizations are ineligible shareholders, these sources of capital are unavailable to S corporations, again placing them at a competitive disadvantages to C corporations.

> Example: The founder of an S corporation wants to retire and would like to sell the business to its employees. To obtain the financing required for an employee purchase, a C corporations would normally establish an ESOP. However, this S corporation owner will likely be forced to sell to outside interests and not to the employees because an ESOP is an ineligible shareholder.

We recommend tax-exempt organizations become eligible to hold stock in S corporations. This proposal would allow the partnership flow-through approach to be used with exempt organization shareholders of an S corporation. For example, any trade or business income allocable to the exempt organization shareholder would be subject to the unrelated business income tax, or UBIT, but interest and dividend income would not.

Allow nonresident alien shareholders to own S corporation stock. *Pamphlet, section D.4.a.3.*

Under current law, a nonresident alien is not an eligible shareholder for purposes of a valid S corporation election. This presents a problem for S corporations, because frequently, sources of capital or entre to foreign markets require an equity participation by a nonresident alien.

> Example: A local S corporation manufacturer has an opportunity to expand sales into the European market. A European individual who will manage oversees marketing wants to invest in a minority equity position in the company. The restriction on ownership of S corporation stock by nonresident alien shareholders forces the manufacturer to either give up its S corporation status or resort to unnecessarily sophisticated and expensive tax planning techniques.

We recommend that nonresident aliens (individuals only) be treated as eligible shareholders. Under this recommendation, any effectively connected U.S. income allocable to the nonresident alien should be subject to a withholding tax similar to the tax imposed on nonresident partners of a partnership.

Permit S corporations to issue preferred stock. *Pamphlet, section D.4.b.1.*

Under current law, an S corporation is permitted to have only one class of stock. This presents a serious problem for S corporations seeking venture capital, because venture capitalists and other outside sources of funding generally require an equity position that provides a preferred return with the upside potential for capital gain to enhance the rate of return on investment.

> Example: A small S corporation has developed a promising new product. To bring it to market, it requires outside investment capital. With family and commercial bank sources of capital exhausted, it now seeks venture capital. As an S corporation, it is precluded from offering venture capitalists an economically attractive investment opportunity.

We recommend that S corporations be permitted to issue preferred stock, including convertible preferred stock. Under this proposal, only eligible S corporation shareholders would be allowed to own preferred stock.

Permit an S corporation to own more than 80 percent of a C corporation's stock. *Pamphlet, section D.4.c.*

Under current law, an S corporation may own as much as 79 percent of the stock of another corporation without jeopardizing the S election. Yet, for valid, nontax business reasons, corporations frequently establish subsidiaries to hold their different business activities. Normally, these would be wholly-owned subsidiaries. An S corporation is precluded from using this ownership structure because of the prohibition on affiliated companies. Currently, this business goal can only be accomplished by using inefficient and costly tax planning techniques.

> Example: A local general construction company, organized as an S corporation, has developed expertise in asbestos abatement and removal. However, concerns about potential liability exposure may cause the corporation to withdraw from this business, unless it can be dropped into a subsidiary.

We recommend that a corporation be permitted to elect S status regardless of the percentage of stock it owns in a C corporation subsidiary. However, we also recommend that no S corporation be permitted to participate in any consolidated returns.[4]

Permit S corporations to own S corporation stock. *Pamphlet, section D.4.c.*

Under current law, S corporations are not permitted to have corporate shareholders. While the preceding proposal would allow wholly-owned subsidiaries, those subsidiaries would be denied flowthrough treatment. (The subsidiary could not itself be an S corporation because S corporations cannot have corporations as shareholders.) This defeats the objective of subchapter S in permitting flowthrough treatment for the entire business.

In the preceding example, the asbestos subsidiary, if organized, would be restricted to C corporation status. It is inappropriate to deny flowthrough treatment where business reasons necessitate the use of a subsidiary. To obtain flowthrough treatment under current law, the owners of the construction company could form a new "sister" corporation to engage in the asbestos removal business. This alternative is an unnecessarily inefficient and costly corporate structure.

We recommend that an S corporation be permitted to own 100 percent of the stock of another S corporation, as well as a chain of S corporations. The corporate group should not, however, be permitted to file consolidated returns.

<u>Expand "safe harbor straight debt" to permit convertible debt. *Pamphlet, section D.4.b.2.*</u>

Under current law, it is possible that debt may be recharacterized as a second class of stock. However, an obligation that qualifies as "straight debt" is not considered a second class of stock and, thus, does not trigger a termination of the S election. For example, if the debt contains conversion and liquidation rights, which "straight debt" is not permitted to contain, the entity's S election could be in jeopardy.

The problem this presents is that in today's business world debt instruments frequently contain convertibility features. Under current law, S corporations are at risk that this convertible debt could be construed as a "second class of stock" which would terminate S status. This common debt feature should not terminate S status. While current regulations offer some flexibility, these rules do not adequately resolve this problem.

We recommend, therefore, that the "straight debt" safe harbor provisions be expanded to allow the issuance of convertible debt. However, the debt instrument in question should be required to continue to meet all of the other criteria of straight debt.

<u>Expand "safe harbor straight debt" to permit ineligible shareholders to hold the debt. *Pamphlet, section D.4.b.3.*</u>

Under current tax law, "straight debt." may only be owned by an individual, an estate, or a trust which is eligible to be an S corporation shareholder. This presents a problem because loans from financial institutions and other arms-length borrowing would not be treated as safe harbored straight debt.

To expand financing opportunities for S corporations, we recommend the definition of straight debt be expanded so that loans from financial institutions and other lenders not be subjected to greater restrictions than loans made by others.

PRESERVE FAMILY-OWNED BUSINESSES

Expand trusts permitted to own S corporation stock to include those with multiple income beneficiaries, the ability to accumulate trust income, and trustee powers to spray income among the beneficiaries. *Pamphlet, section D.4.a.4.*

Under current law, only certain types of trusts are permitted to become shareholders of an S corporation, the two most common types of eligible trust shareholders including the grantor trust and the "qualified subchapter S trust" (QSST). The problem this presents for S corporation owners is that the most common trusts used for estate planning purposes have multiple beneficiaries and sprinkling powers vested in the trustee. These trusts are not allowed to hold S corporation stock. As a result, S corporation shareholders do not have access to the same estate planning techniques available to C corporation owners.

> Example: An S corporation owner has an ailing spouse and several children. To properly provide for the family at the owner's death, the owner will probably want to use a trust that allows the trustee to make distributions to care for the medical needs of the ailing spouse and the varying educational needs of the children. To accomplish this, the owner will need to terminate S corporation status or result to unnecessarily complicated and expensive estate planning techniques.

We recommend expansion of the definition of what constitutes a QSST. Under this expanded definition, single-tier trusts would be permitted to have multiple-income beneficiaries and to accumulate income from the S corporation at the trust level. Sprinkle trusts would be treated as eligible S corporation shareholders. Multiple beneficiaries would each, along with the trust, be counted as shareholders. However, the family attribution rules would apply in counting the number of shareholders.

Count all members of a single family who own an S corporation's stock as a single shareholder. *Pamphlet, section D.4.a.5.*

Under current law, only a husband and wife are treated as one shareholder for purposes of the S corporation election. All other members of a family are treated as separate shareholders. For multi-generational, family-held businesses, an artificial limit on the number of shareholders prevents corporations from continuing to operate as an S corporation for future generations.

> Example: A furniture manufacturing company now owned by the second and third generations of the two founding families is an S corporation. Currently they have 25 shareholders. Mathematically, the S corporation status will not be able to be continued into the next generation. Under this proposal, solely for purposes of the 35-shareholder limitation, the corporation would be treated as having only two shareholders. For all other purposes, all actual shareholders would be treated as shareholders.

We recommend the family attribution rules under Code section 267(c)(4) apply in the situation of the S corporation election. This means that all family members would be treated as one S corporation shareholder, in determining the if the current thirty-five (for our recommended fifty) shareholder limit is exceeded.

REMOVE UNDESIRABLE TAX TRAPS

Permit shareholder personal guarantees of corporate debt to increase shareholder basis. *Pamphlet, section D.4.d.*

Under current tax law, a partner includes his or her share of partnership indebtedness in his or her basis (in the partnership) for loss deduction purposes. In contrast, an S corporation shareholder is not permitted to include indebtedness of the S corporation in his stock basis, even to the extent the shareholder has provided a personal guarantee of the corporate debt.

Current law emphasizes form over substance. When an S corporation needs additional funds, typically a commercial bank will make the loan directly to the corporation with the additional security of a shareholder guarantee. A well-advised S corporation owner would structure the financing arrangement so that the bank would make the loan to the shareholder who would then reloan the borrowed funds to the corporation. In both cases, the shareholder is economically exposed to repay the loan to the bank. Yet, basis is available only if the shareholder is well-advised before the loan is made.

> Example: An S corporation nursery and landscaping business needs additional funds for expansion. The corporation borrows from a bank and the owner personally guarantees the debt. The guarantee does not increase the owner's basis. If the owner had first incurred the expense of consulting a tax advisor, the advisor would have recommended using "back-to-back" loans, which could have resulted in basis to the shareholder without any economic difference to any party—except for the fee paid to the tax advisor.

We recommend that to the extent an S corporation shareholder personally guarantees indebtedness of the S corporation, the shareholder should be permitted to reflect the personal guarantee as part of basis in the entity for loss deduction purposes. To minimize the complexity of this proposal, we recommend that the guarantees available for this treatment be limited to those which have a single guarantor and specifically state the amount guaranteed.

Permit the Secretary of Treasury to treat invalid elections as effective. *Not included in Pamphlet.*

Under current law, the IRS has the authority to waive the effect of an inadvertent S corporation termination, but not the authority to waive the effect of an invalid election caused by an inadvertent failure to qualify as an S corporation.

We believe the IRS should have the authority to waive an inadvertent invalid S corporation election for entities that have subsequently cured the defect. This new authority would be a broadening of the current IRS authority to waive the effect of an inadvertent S corporation termination.[4]

<u>Provide for automatic waiver of certain inadvertent terminations. *Pamphlet, section D.4.f.*</u>

Under current law, the IRS has the authority to waive the effect of an inadvertent S corporation termination and *may* have authority to *automatically* waive such effect. A high percentage of private letter ruling requests on S corporations deal with the issue of inadvertent terminations. For many taxpayers, obtaining a waiver of their terminated S status can result in costly professional fees. Also, valuable time on the part of IRS personnel and tax professionals is lost on processing routine taxpayer waiver requests.

We recommend an automatic waiver procedure be authorized by Congress so that an entity would not lose its S corporation status due to a terminating event of a "ministerial" nature. An example of such an event is when a beneficiary fails to make a qualified subchapter S trust election.

<u>Repeal excessive passive investment income as a termination event. *Pamphlet, section D.4.e.*</u>

Under current law, subchapter S contains two disincentives to discourage "incorporated pocketbooks" from operating as S corporations. First a corporate-level tax is imposed on excess passive investment income. Second, S status is terminated if the corporation earns passive investment income that exceeds 25 percent of the entity's gross receipts for three consecutive taxable years and the entity has accumulated Subchapter C earnings and profits at the end of each of the three years.

While this result may be avoided through proper tax planning, many unadvised S corporations are caught unaware of these traps and lose their S status. The sanction of terminating S status when the entity has excessive passive income is unduly harsh.

> Example: Due to business fluctuations, the operating business of an S corporation declines over a period of several years. During the recession, a substantial portion of the corporation's income is derived from passive sources. Without proper advice, this corporation may not realize that its S status will terminate if this situation continues for three years.

To the extent Congressional intent is to limit the passive income of an S corporation, we believe this legislative intent is sufficiently served through the current procedures of imposing a corporate-level tax on the S corporation's passive income. Therefore, the sanction of terminating the S election in the situation of excessive passive income should be repealed.

<u>Exclude trade or business income from the passive investment income definition. *Pamphlet, section D.4.e.*</u>

Under current law, the definition of passive investment income for S corporation purposes includes the types of income earned by a personal holding company, and many traditional types of active trade or business income earned by an operating company. By including certain types of active trade or business income in the passive investment income definition, many operating companies are precluded from making the S election.

> Examples: Examples of such operating companies include certain rental real estate operators and certain corporations earning royalty income from the franchising of a product, process, or service.

We recommend the income earned from the active conduct of a trade or business not be included in the S corporation definition of passive income. Instead, a facts and circumstances test should be adopted to determine what constitutes active as opposed to passive income. Examples of regulations that may be used in drafting a facts and circumstances test include Regulation sections 1.355-3(b) and 1.469-2T(c)(3)(i).

TECHNICAL PROPOSALS

Treat losses on liquidation of S corporations as ordinary to the extent the loss created by ordinary income passthrough triggered the liquidation. *Pamphlet, section D.4.h.*

Under current law, if an S corporation sells an appreciated asset or distributes it to shareholders, the appreciation in value of the asset is generally taxed once—at the shareholder level. The gain recognized in such dispositions can be characterized either as capital gain or ordinary income, depending on the asset being sold or distributed. Any recognized gain or income increases the basis of S corporation shareholders in their stock. If the S corporation liquidates, any loss on liquidation will generally be a capital loss, even if, in the process of liquidation, ordinary income is recognized on assets sold or distributed. In other words, a shareholder can receive a flowthrough of ordinary income and resulting increase in basis as a result of disposition of assets in liquidation. But any loss on the liquidation will generally be capital loss, even if the basis was created by a transaction resulting in ordinary income.

We recommend that the loss recognized by a shareholder on the complete liquidation of an S corporation be treated as ordinary rather than capital to the extent the shareholder's basis in the S corporation stock is attributable to ordinary income, that was recognized as a result of the liquidation.

Allow a carryover of disallowed losses and deductions under section 465 to the post-termination transition period. *Pamphlet, section D.4.i.*

Under current law, losses of S corporation shareholders suspended by the subchapter S basis rules, may be recognized after the S election terminates and during the post-termination transition period if additional basis in the S corporation is generated during such period. S corporation losses may also be suspended under the at-risk rules. S corporations and their shareholders are treated in the same fashion as partners in partnerships under the at-risk rules. However, losses suspended through the application of the at-risk rules are *not* carried over to the post-termination transition period for the (former S corporation) entity.

The post-termination transition period rule allows a last-chance opportunity for S corporation shareholders to establish basis in the corporation and thus use losses that had passed through to them in previous years but that were nondeductible because of a lack of basis at that time. However, in some cases, S corporation shareholders have had enough basis to deduct losses, but the losses were suspended under the at-risk rules for which there is no post-terminations transition period opportunity. To provide a last chance opportunity for these losses, it is appropriate to extend current law treatment of losses suspended because of insufficient basis to losses suspended under the at-risk rules.

We recommend losses suspended in the application of the at-risk rules be permitted to be carried over to the post-termination transition period.

<u>Expand the period of post-death S qualification for certain trusts.</u> *<u>Pamphlet, section D.4.j.</u>*

Under current law, a testamentary trust is permitted to be a shareholder of an S corporation for a period not to exceed 60 days following the death of a deceased S corporation shareholder. There is also a similar 2 year rule for grantor trusts and deemed grantor trusts. After the 60-day period, the trust must transfer ownership of the shares to an eligible S corporation shareholder or (if qualified) become a Qualified Subchapter S Trust. There is a two-year rule for those trusts with corpus included in grantor's estate.

The requirement that the trust transfer ownership of its S corporation shares within the 60-day period is a significant compliance and administrative burden for many taxpayers. The trustee may be unaware of the need to transfer the S corporation stock until advised to do so by a tax advisor who is involved in the administration of the decedent's estate. Often, this may not occur until more than sixty days following the decedent's death.

> Example: The owner of a 20% interest in the stock of an S corporation that operates a farm equipment dealership provided in her will that on her death her stock would pass to a testamentary trust. A family member was named the trustee. The shareholder died on April 15, 1992. Not until August, 1992, when the estate's executor began detailed work on information for the estate tax return did the trustee discover that the S corporation stock should have been transferred out of the trust within 60 days after the shareholder's death. As a result, the corporation's S election terminated on the sixty-first day.

The period of time that the trust may own the S corporation stock should be extended to two years (the same as for grantor trusts). By enacting a two-year period, Congress would be taking positive steps to relieve compliance and inadvertent termination problems.

Modify order of adjustments to Accumulated Adjustments Account (AAA) and stock basis. *Pamphlet, section D.4.k.*

Under current law, adjustments are made to the basis of an S corporation shareholder's stock in the sequence of income first, losses second, and distributions third. On the other hand, partnership basis is adjusted first by income, second by distributions, and third by losses.

We believe the subchapter K rules involving the ordering of adjustments to basis should also apply in determining the basis of S corporation stock and the S corporation AAA. Thus, for purposes of subchapter S, distributions under this proposal would be taken into account before losses.[4]

Permit consent dividend for AAA by-pass election. *Not included in Pamphlet.*

Under current law, certain adverse consequences, including termination of the S election caused by excess passive investment income, can accrue to an S corporation which retains earnings and profits from the time it was a C corporation. C corporation earnings and profits can be purged from the corporation by making a shareholder distribution. Normally, such distributions are first made out of AAA. However, an election is available to by-pass AAA and make the distribution out of C corporation earnings and profits. Proposed regulations under section 1368, if finalized, would permit a corporation to elect consent dividend treatment to by-pass the AAA and distribute out its C corporation earnings and profits. (A consent dividend allows the corporation to make a deemed distribution to shareholders followed by a deemed contribution by those shareholders back to the corporation.)

Without a consent dividend procedure, distributions must be made with cash or other assets which, frequently, are not available at the appropriate time to make a distribution. A consent dividend procedure solves this problem. But some argue there may not be sufficient administrative authority to provide a consent dividend procedure in the regulations.

We support the consent dividend treatment provision of the proposed regulations and, therefore, recommend this particular provision of the regulations be codified.

Permit subchapter C to apply to S corporations in certain circumstances. *Not included in Pamphlet.*

Under current law, an S corporation in its capacity as a shareholder of another corporation is treated as an individual for purposes of subchapter C. The IRS has taken the position that this prevents the tax-free liquidation of a C corporation into an S corporation under the rationale a C corporation cannot liquidate tax-free when owned by an individual. Recently, the Service has indicated that it may be changing this position,[5] but we believe this latter position should be codified.

We recommend repeal of the rule which treats an S corporation in its capacity as a shareholder of another corporation as an individual. Under this recommendation, the liquidation of a C corporation into an S corporation will be governed by the generally applicable subchapter C rules.[4]

Elimination of pre-1983 subchapter S earnings and profits. *Not included in Pamphlet.*

Under current law, the accumulated earnings and profits of a corporation are not increased for any year in which an election to be treated as an S corporation is in effect. However, under the subchapter S rules in effect prior to 1983, a corporation electing S status for a taxable year increased its accumulated earnings and profits if, for the year, they exceeded both taxable income and distributions out of that year's earnings and profits. The Subchapter S Revision Act of 1982 repealed this rule for earnings attributable to taxable years beginning after 1982 but did not do so for previously accumulated S corporation earnings and profits.

We recommend that a corporation's accumulated earnings and profits be solely attributable to taxable years for which an S election was not in effect. This recommendation involves the elimination of S corporation earnings and profits attributable to periods preceding the effective date of the Subchapter S Revision Act of 1982.[4]

Simplify the procedures for electing to close the books on the termination of a shareholder's interest. *Pamphlet, section D.4.l.*

Under current law, a corporation may elect to close its books at the date of complete termination of a shareholder's interest. All shareholders (including those who held shares at any time during the year) must give their consent to this election. This requirement imposes compliance burdens in the preparation and filing of timely corporate tax returns. According to the holding in an IRS private letter ruling, even if a corporation does not have the consensus of unaffected shareholders, it still may be in "substantial compliance" with the tax law when the allocations were prepared correctly.

Under current law, all shareholders of the corporation must consent to this election, including those that are unaffected. The necessity of obtaining the signatures of these unaffected shareholders imposes an unreasonable administrative burden, especially when the corporation is owned by multiple shareholders. Rather, the election should only be made by those affected shareholders, that is, those who were involved in a stock transaction during the year.

> Example: A small manufacturing business is owned by 24 shareholders. During the year, one of the shareholders sells her stock to an outsider. Because income is not earned ratably throughout the year, the parties decide that they wish to close the books at the date of sale, rather than allocate income as if it were earned ratably throughout the year. This election acts only to allocate income between the buyer and seller. It has no impact on the other 23 shareholders. Under current law, this consent must be obtained from all

24 shareholders no matter how small their stockholdings. This can unfairly hold the election hostage to shareholders who are unaffected by the election.

Instead of having to obtain the consent of all shareholders, we recommend the closing of a corporation's books be permitted if both the affected shareholders and corporation consent.

Expand the post-termination transition period. *Pamphlet, section D.4.m.*

Under current law, if an entity loses its S corporation status, it may distribute cash to shareholders during the post-termination transition period. The distribution is then applied against the adjusted basis of the stock. The shareholder receives the cash tax free to the extent the amount distributed does not exceed the Accumulated Adjustments Account (AAA). If there is excess, it is treated as capital gain. Also, the AAA ceases to exist for tax purposes at the end of the post-termination transition period. Distributions made after the post-termination transition period are taxed under the regular Subchapter C provisions.

Because of the large number of occurrences that can terminate a corporation's S election, an S corporation and its shareholders may be unaware of a termination until an IRS examination in a subsequent year brings the facts to light. In such situations where inadvertent termination relief may not be available, the period within which to make post-termination distributions may already have elapsed.

> Example: A shareholder of an S corporation irrevocably transferred stock to a trust that he believed in good faith to be an eligible S corporation shareholder. Two years later, an IRS examination determined that the trust was not eligible. Under the terms of the trust agreement, the stock cannot be transferred out of the trust. Accordingly, inadvertent termination relief is unavailable. Since the post-termination transition period has elapsed, the corporation is unable to make a tax-free distribution of its AAA.

We recommend a broadening of the definition of post-termination transition period with respect to the 120-day period following a determination that the corporation's election had terminated for a previous taxable year.

EXPANSION OF RECOVERY PERIOD FOR NONRESIDENTIAL PROPERTY

The present Budget Reconciliation Bill contains a provision extending the depreciable life (the "recovery period") of nonresidential realty from its present 31.5 years to 39 years. We have previously testified in opposition to this provision. If, however, Congress believes it important to lengthen the life of business realty, we believe you should consider the following. As the building life for tax depreciation approaches its economic life, tenants and landlords paying for leasehold improvements may become more disadvantaged. Tenants with short-term leases must depreciate improvements for which they pay over the statutory life (which would now be 39 years), even though a lease may be for only 10 or 15 years.

As to landlords, improvements are usually specialized to the particular tenant's needs and do not usually have much, if any, economic value at the conclusion of the lease period. As a result of this, landlords who are already disadvantaged by the present 31.5 year recovery period would be put at an even greater disadvantage as a result of the requirement to use a 39-year life for leasehold improvements.

> Example: Assume a landlord agrees to invest $390,000 for tenant improvements in order to entice a tenant to sign a ten-year lease. At the end of the lease term, the landlord would have depreciated 10/39 of the cost but is not entitled to write off the remaining $290,000 of cost even though it has little or no economic value. Such cost is capitalized as a part of the building cost and cannot be written off even if the associated assets are abandoned. If at that time the landlord must make the same arrangement in order to secure a new tenant ($390,000 of additional tenant improvements) he now has an undepreciated balance of $680,000 (the remaining $290,000 plus the new $390,000) for tenant improvements that are worth $390,000.

If the cost recovery period for business real estate is extended to 39 years, we believe Congress should legislate a separate, shorter, depreciation class for leasehold improvements and for other known shorter-life assets, which presently are keyed to the recovery period of the overall building.

* * * * *

Once again, we appreciate the opportunity to present our views here today and we stand ready to assist you in any way.

1. These figures are for 1990, the most recent year for which data is available. *See*, "Table 13.—Corporation Income Tax Returns: Balance Sheet, Income Statement and Tax Items for Specified Income Years, 1970-1990", *SOI Bulletin*, Vol 12, Number 4 (Spring 1993).

2. References to the pamphlet are to the *Joint Committee on Taxation Staff Description (JCS-8-93) of Miscellaneous Tax Proposals Scheduled for Hearings June 17, 22, and 24, before House Ways and Means Select Revenue Subcommittee, Issued June 16, 1993.*

3. This proposal was included in H.R. 11, the *Revenue Act of 1992*, which was vetoed by President Bush.

4. This proposal was included as a measure in H.R. 13, *the Tax Simplification Act of 1993.*

5. *See*, Technical Advice Memorandum 9245004 (July 28, 1992), a form of nonprecedential administrative guidance.

IMPROVING SUBCHAPTER S

A PRESCRIPTION FOR SMALL BUSINESS

INTRODUCTION

In 1958, Congress introduced Subchapter S to the Internal Revenue Code to make the choice of the form in which a small business operates (whether as a proprietorship, partnership, or corporation) a more neutral decision. Before 1986, relatively few small businesses availed themselves of the benefits of operating under Subchapter S, the primary one being corporate integration. This, despite the *Subchapter S Revision Act of 1982* (the "*1982 Act*"), a landmark piece of legislation that simplified and improved the subchapter.

After the monumental changes introduced by the *Tax Reform Act of 1986* (the "*1986 Act*"), small businesses rushed to use the S Corporation format. Appendix Table 1 of "S Corporations Since the Tax Reform Act of 1986," the study contained in Section 6 of this briefing book, indicates that between 1985 and 1988, the filing of S Corporation tax returns grew from 725,000 to 1,257,000, a 73% increase. As a share of total corporate filings, tax returns of S Corporations grew from 22.1% in 1985 to 35.3% in 1988.

This means that a significant number of corporations shifted from the classical two-tier system of corporate taxation to a nearly pure flow-through system. Some tax policy analysts are concerned that making Subchapter S available to even more small businesses would be harmful to the public fisc at a time of severe deficits. Yet, this is unlikely because the types of corporations that have elected S Corporation status remains relatively small. Again Appendix Table 1 of the study in section 6 bears this out. In 1985, of all the assets owned by corporations in the United States, 1.6% were owned by S Corporations. By 1988, after the phenomenal growth of S corporation filings, the percentage of total corporate assets owned by S corporations had grown to only 3.5%. While some large S corporations do exist, clearly the vast majority are small businesses.

The *1982 Act* was an important piece of legislation, simplifying Subchapter S, removing a number of traps in the operation of S corporations, and closing some loopholes. The *1982 Act* paved the way for the exodus from the two-tier corporate tax system occasioned by the 1986 Act. But more work needs to be done with Subchapter S.

- The current structure unnecessarily places small businesses operating as S corporations at a disadvantage in obtaining financing.
- Owners of S corporations suffer some serious strictures in planning the disposition of their estates and the succession of corporate control, strictures not encountered by their counterparts who own C corporations.
- S corporations which, for nontax reasons, need to place portions of their businesses in separate corporate entities are precluded from doing so under the current Subchapter S structure.
- Some unnecessary traps remain, most notably the rules applying to shareholders who

guarantee corporate debt and the termination of the S election caused by corporations receiving passive income.

- S corporation owners are disadvantaged in the employee benefits area vis á vis C corporation owners.

All these factors serve as impediments to using Subchapter S, and none have continuing merit from a tax policy perspective.

Small business has changed a great deal since Subchapter S was introduced in 1958. It has even matured significantly since the *1982 Act*. Small businesses turn to venture capitalists now, and not simply banks, for needed capital. Complicated corporate structures are much more common in this age of litigation. For these and other reasons the time has come to improve Subchapter S once again to - adjust the subchapter to the modern realities of sophisticated small businesses, remove impediments that have become unnecessary as tax policy considerations change, and to unleash the productive capacity of the nation's small businesses.

April 1993

S CORPORATION WORKING GROUP
SUMMARY OF DRAFT LEGISLATION

The S Corporation Working Group has developed this outline for an S corporation reform bill for introduction in Congress in 1993. This initiative is designed to reform the current S corporation rules and eliminate many traps for the unwary, resulting in improvements in the capital formation opportunities of small business. The legislation will also contribute to the preservation of family-owned businesses by removing impediments to the transfer of a firm from one generation to the next. By ensuring continuance of the family-owned business and through enhancement of a small firm's access to capital, the reform bill should result in an increase in jobs and prosperity for the American work force. In general, the reform bill removes arbitrary limitations on S corporation shareholders, allows S corporations to issue preferred stock under certain circumstances, expands the types of debt instruments which an S corporation may issue, treats S corporation shareholder-employees more equitably with respect to fringe benefits, and makes various other improvements.

Participants in the S Corporation Working Group include representatives of the American Bar Association S Corporation Committee, the American Institute of Certified Public Accountants S Corporation Taxation Committee, the S Corporation Tax Study Group, the U.S. Chamber of Commerce, and others. The proposed S corporation reform bill as summarized below, reflects the personal views of the participants in the S Corporation Working Group, and do not necessarily reflect the views of the organizations they represent. The proposed legislation, therefore, must be reviewed and approved by the appropriate policy committees of each organization before it can become an official position of such organization.

The S Corporation Taxation Committee of the AICPA has reviewed this report and has voted to conceptually support the proposal without reservation. The S Corporation Committee's sole concern is related to implementation issues; e.g., where S corporations would be permitted to own other S corporations. This AICPA committee has indicated that position papers will be required to evaluate these implementation issues. In addition, this summary and these position papers will require approval of the AICPA's Tax Executive Committee.[1]

With respect to the S Corporation Committee of the American Bar Association Tax Section, the committee has voted to endorse the proposals contained in this report. However, the proposals have not been acted upon or approved by the American Bar Association or its Taxation Section and accordingly, the views of the members of the

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1 On November 20, 1992, the AICPA Tax Executive Committee approved this proposal. The Tax Executive Committee is a senior technical committee of the AICPA and is authorized to speak on behalf of the AICPA on matters related to taxation.

American Bar Association's S Corporation Committee are expressed in their individual capacity only.

The S Corporation Tax Study Group has also reviewed this report, and conceptually supports the proposals contained in the reform initiative. However, they too have noted that implementation and other issues will arise when these proposals are reduced to legislative language.

Further, the U.S. Chamber's Taxation Committee has reviewed this report, and has voted to generally support the proposals.

SHAREHOLDER LIMITATIONS

1. Thirty five shareholder limitation.

Current Law: Among other criteria, an S corporation election is not valid if the business has more than 35 shareholders.

Problem: For multi-generational family-held businesses, an artificial limit on the number of shareholders prevents corporations from continuing to operate as an S corporation for future generations. Also, some high-tech corporations that want to reward key employees are artificially limited to a thirty-five shareholder limitations.

> Example: A furniture manufacturing company now owned by the second and third generations of the two founding families is an S corporation. Currently they have 25 shareholders. Mathematically, the S corporation status will not be able to be continued into the next generation.

Recommendation: The current S corporation limit of 35 shareholders is an arbitrary standard which serves to restrict capital formation opportunities of smaller firms. The S Corporation Working Group recommends that the current limit be raised to 50 shareholders. (This proposal was included as a measure in H.R. 11, the Revenue Act of 1992.)

LEGISLATIVE LANGUAGE: H.R. 11 § 7601(a).

> (a) S Corporations Permitted to Have 50 Shareholders.—Subparagraph (A) of section 1361(b)(1) (defining small business corporation) is amended by striking "35 shareholders" and inserting "50 shareholders".

2. **Permit tax exempt organizations as eligible shareholders.**

Current Law: A tax exempt organization is not an eligible shareholder for purposes of a valid S corporation election.

Problem: Tax exempt organizations including pension plans, ESOPs (a qualified employee stock ownership plan), university endowment funds are a significant source of capital for small closely-held businesses seeking to expand their operations. Because tax exempt organizations are ineligible shareholders, these sources of capital are unavailable to S corporations. This places them at a competitive disadvantages to C corporations.

> Example: The founder of an S corporation wants to retire and would like to sell the business to its employees. To obtain the financing required for an employee purchase, a C corporations would normally establish an ESOP. However, this S corporation owner will likely be forced to sell to outside interests and not to the employees because an ESOP is an ineligible shareholder.

Recommendation: The Group recommends that tax exempt organizations become eligible to hold stock in S corporations. This proposal would allow the partnership flow-through approach to be used with exempt organization shareholders of an S corporation. For example, any trade or business income allocable to the exempt organization shareholder would be subject to the unrelated business income tax, or UBIT, but interest and dividend income would not.

LEGISLATIVE LANGUAGE: No Legislative Language.

3. **Allow nonresident alien shareholders as eligible shareholders.**

Current Law: A nonresident alien is not an eligible shareholder for purposes of a valid S corporation election.

Problem: Frequently, sources of capital or entre to foreign markets requires an equity participation of a nonresident alien.

> Example: A local S corporation manufacturer has an opportunity to expand sales into the European market. A European individual who will manage oversees marketing wants to invest in a minority equity position in the company. The restriction on ownership of S corporation stock by nonresident shareholders forces the manufacturer to either give up its S corporation status or resort to unnecessarily sophisticated and expensive tax planning techniques.

Recommendation: The Group recommends that nonresident aliens (individuals only) be treated as eligible shareholders. Under this recommendation, any effectively connected U.S. income allocable to the nonresident alien should be subject to a withholding tax similar to the tax imposed on nonresident partners of a partnership.

LEGISLATIVE LANGUAGE: ABA Proposal to amend §§ 875, 894, 1361(b)(1)(C), and 1446.

<u>SECTION 875</u>:

[Sec. 875]

SEC. 875. PARTNERSHIPS; <u>S CORPORATIONS</u>; BENEFICIARIES OF ESTATES AND TRUSTS.

For purposes of this subtitle--

(1) a nonresident alien individual or foreign corporation shall be considered as being engaged in a trade or business within the United States if the partnership <u>or S corporation</u> of which such individual or corporation is a member or shareholder is so engaged, and ...

<u>SECTION 894</u>:

[Sec. 894(c)]

<u>(c) PERMANENT ESTABLISHMENT OF PARTNERS AND S CORPORATION SHAREHOLDERS.-- A nonresident alien individual or foreign corporation which is a partner of a partnership, or a nonresident alien individual who is a shareholder of an S corporation, which partnership or S corporation has a permanent establishment in the United States during the taxable year within the meaning of a treaty to which the United States is a party, shall be deemed to have a permanent establishment in the United States within the meaning of such treaty</u>.

<u>SECTION 1361(b)(1)(C)</u>:

[Sec. 1361(b)]

(b) SMALL BUSINESS CORPORATION.--

~~(C) have a nonresident alien as a shareholder, and~~

4. Expand the types of trusts permitted to be S corporation shareholders.

Current Law: Only certain types of trusts are permitted to become shareholders of an S corporation. The two most common types of eligible trust shareholders include the grantor trust and the "qualified subchapter S trust" (QSST).

Problem: The most common trusts used for estate planning purposes have multiple beneficiaries and sprinkling powers vested in the trustee. These trusts are not allowed to hold S corporation stock. As a result, S corporation shareholders do not have access to the same estate planning techniques available to C corporation owners.

> Example: A S corporation owner has an ailing spouse and several children. To properly provide for the family at the owner's death, the owner will probably want to use a trust that allows the trustee to make distributions to care for the medical needs of the ailing spouse and the varying educational needs of the children. To accomplish this, the owner will need to terminate S corporation status or result to unnecessarily complicated and expensive estate planning techniques.

Recommendation: The Group recommends expansion of the definition of what constitutes a QSST. Under this expanded definition, single-tier trusts would be permitted to have multiple income beneficiaries and to accumulate income from the S corporation at the trust level. Sprinkle trusts would be treated as eligible S corporation shareholders. Multiple beneficiaries would each, along with the trust, be counted as shareholders. However, the family attribution rules would apply in counting the number of shareholders.

LEGISLATIVE LANGUAGE: No Legislative Language.

CONSTRUCTIVE OWNERSHIP

1. Shareholder counting conventions -- application of constructive ownership rules.

Current Law: Only a husband and wife are treated as one shareholder for purposes of the S corporation election. All other members of a family are treated as separate shareholders.

Problem: For multi-generational family-held businesses, an artificial limit on the number of shareholders prevents corporations from continuing to operate as an S corporation for future generations.

Example: A furniture manufacturing company now owned by the second and third generations of the two founding families is an S corporation. Currently they have 25 shareholders. Mathematically, the S corporation status will not be able to be continued into the next generation. Under this proposal, solely for purposes of the 35-shareholder limitation, the corporation would be treated as having only two shareholders. For all other purposes, all actual shareholders would be treated as shareholders.

Recommendation: The Group recommends that the family attribution rules under Code section 267(c)(4) apply in the situation of the S corporation election. This means that all family members would be treated as one S corporation shareholder.

LEGISLATIVE LANGUAGE: ABA proposal to amend § 1361(c)(1).

<u>SECTION 1361</u>:

[Sec. 1361(c)]

(c) SPECIAL RULES FOR APPLYING SUBSECTION (b).--

(1) ~~HUSBAND AND WIFE~~ <u>FAMILY MEMBERS</u> TREATED AS 1 SHAREHOLDER.--For purposes of subsection (b)(1)(A), ~~a husband and wife~~ <u>members of the same family (as defined in section 267(c)(4))</u> and their estates shall be treated as one shareholder.

PREFERRED STOCK

1. Permit S corporations to issue preferred stock.

Current Law: An S corporation is permitted to have only one class of stock.

Problem: Venture capitalists and other outside sources of funding generally require an equity position that provides a preferred return with the upside potential for capital gain to enhance the rate of return on investment.

Example: A small S corporation has developed a promising new product. To bring it to market, they require outside investment capital. They have exhausted family and commercial bank sources of capital and now seek venture capital. As an S corporation, they are precluded from offering venture capitalists an economically attractive investment opportunity.

Recommendation: The Group recommends that S corporations be permitted to issue preferred stock, including convertible preferred stock. Under this proposal, only eligible S corporation shareholders would be allowed to own preferred stock.

LEGISLATIVE LANGUAGE: ABA proposal to amend § 1361(c)(7). [Note: The ABA proposal would allow for convertible preferred stock, without specifically so stating. However, the Working Group would prefer that the statute explicitly permit stock with a convertibility feature to qualify.]

SECTION 1361:

[Sec. 1361(c)]

(7) QUALIFIED PREFERRED STOCK. For purposes of this subchapter, the term "qualified preferred stock" shall mean stock, which is identical to the corporation's issued and outstanding common stock except that the holders thereof are entitled to receive a specified minimum amount and/or percentage of the corporation's earnings prior to any distributions to the holders of the corporation's common stock.

SUBSIDIARIES

1. Permit an S corporation to own more than 80 percent of another corporation's stock.

Current Law: An S corporation may own as much as 79 percent of the stock of another corporation without jeopardizing the S election.

Problem: For valid nontax business reasons, corporations frequently establish subsidiaries to hold their different business activities. Normally, these would be wholly-owned subsidiaries. An S corporation is precluded from using this ownership structure because of the prohibition on affiliated companies. Currently, this business goal can only be accomplished by using inefficient and costly tax planning techniques.

> Example: A local general construction company, organized as an S corporation, has developed expertise in asbestos abatement and removal. However, concerns about potential liability exposure may cause the corporation to withdraw from this business, unless it can be dropped into a subsidiary.

Recommendation: The group believes that a corporation should be permitted to elect S status regardless of the percentage of stock that it owns in a C corporation subsidiary. However, the S corporation would not be permitted to participate in any consolidated returns. (This proposal was included as a measure in H.R. 13, the Tax Simplification Act of 1993.)

LEGISLATIVE LANGUAGE: H.R. 13 § 603(b).

> (b) S Corporations Permitted To Hold Subsidiaries.—
> (1) In General.—Paragraph (2) of section 1361(b) (defining ineligible corporation) is amended by striking subparagraph (A) and by redesignating subparagraphs (B), (C), (D), and (E) as subparagraphs (A), (B), (C), and (D), respectively.
> (2) Conforming Amendments.—
> (A) Subsection (c) of section 1361 is amended by striking paragraph (6).
> (B) Subsection (b) of section 1504 (defining includible corporation is amended by adding at the end thereof the following new paragraph:
> "(8) An S corporation."

2. Permit S corporations to own S corporation stock.

Current Law: S corporations are not permitted to have corporate shareholders.

Problem: While the preceding proposal would allow wholly-owned subsidiaries, those subsidiaries would be denied flowthrough treatment. (The subsidiary could not itself be an S corporation because S corporations cannot have corporations as shareholders.) This defeats the objective of subchapter S in permitting flowthrough treatment for the entire business.

In the preceding example, the asbestos subsidiary, if organized, would be restricted to C corporation status. It is inappropriate to deny flowthrough treatment where business reasons necessitate the use of a subsidiary. To obtain flowthrough treatment under current law, the owners of the construction company could form a new "sister" corporation to engage in the asbestos removal business. This alternative is an unnecessarily inefficient and costly corporate structure.

Recommendation: The Group recommends that an S corporation be permitted to own 100 percent of the stock of another S corporation, as well as a chain of S corporations. The corporate group would not be permitted to file consolidated returns.

LEGISLATIVE LANGUAGE: No legislative language.

DEBT

1. Expand safe harbor debt to permit convertible debt.

Current Law: It is possible that debt may be recharacterized as a second class of stock. However, an obligation that qualifies as "straight debt" is not considered a second class of stock and thus, does not trigger a violation of the S election. For example, if the debt contains conversion and liquidation rights, the entity's S election could be in jeopardy.

Problem: Debt instruments frequently contain convertibility features. Under current law, S corporations are at risk that this convertible debt could be construed as a "second class of stock" which would terminate S status. This common debt feature should not terminate S status. While current regulations offer some flexibility, these rules do not adequately resolve this problem.

Recommendation: The "safe harbor debt" provisions of the tax law dealing with S corporations should be expanded to allow the issuance of convertible debt. However, the debt instrument in question must continue to meet all of the other criteria of straight debt.

LEGISLATIVE LANGUAGE: ABA proposal to replace current § 1361(c)(5)(B) with...

<u>SECTION 1361</u>:

[Sec. 1361(c)(5)]

<u>(B) STRAIGHT DEBT DEFINED.--For the purposes of this paragraph, the term "straight debt" means any written unconditional promise to pay on demand or on a specified date a sum certain money if the interest rate (and interest payment dates) are not contingent on profits, the borrower's discretion, or similar factors; provided, however, that if the terms of such promise include a provision whereby the obligation to pay may be converted (directly or indirectly) into or subordinated to stock of the corporation, such terms, taken as a whole, must not be materially different than the terms which could have been obtained on the effective date of the promise from an unrelated party in the trade or business of lending money or providing capital financing</u>.

2. Permit ineligible shareholders to hold safe harbor debt.

Current Law: The Tax Code does not treat debt as a second class of stock if the obligation meets certain requirements. This particular type of debt is called "safe harbor debt." For purposes of safe harbor debt, the creditor must be an individual, an estate, or a trust which is eligible to be an S corporation shareholder.

Problem: A loan from a financial institution would not be treated as safe harbor debt.

Recommendation: To expand financing opportunities for S corporations, the Group believes that loans from financial institutions and other lenders should not be subjected to greater restrictions than loans made by others. Therefore, the Group recommends that loans from lenders be treated as safe harbor debt provided that the loan meets all other requirements for safe harbor debt.

LEGISLATIVE LANGUAGE: ABA proposal to replace current § 1361(c)(5)(B). (See immediately preceding proposal.)

3. **Permit shareholder personal guarantees of corporate debt to increase shareholder basis.**

Current Law: A partner includes his share of partnership indebtedness in his basis (in the partnership) for loss deduction purposes. In contrast, an S corporation shareholder is not permitted to include indebtedness of the S corporation in his stock basis, even to the extent the shareholder has provided a personal guarantee of the corporate debt.

Problem: Current law emphasizes form over substance. When an S corporation needs additional funds, typically a commercial bank will make the loan directly to the corporation with the additional security of a shareholder guarantee. A well-advised S corporation owner would structure the financing arrangement so that the bank would make the loan to the shareholder who would then reloan the borrowed funds to the corporation. In both cases, the shareholder is economically exposed to repay the loan to the bank. Yet, basis is available only if the shareholder is well-advised before the loan is made.

> Example: An S corporation nursery and landscaping business needs additional funds for expansion. The corporation borrows from a bank and the owner personally guarantees the debt. The guarantee does not increase the owner's basis. If the owner had first incurred the expense of consulting a tax advisor, the advisor would have recommended using "back-to-back" loans, which could have resulted in basis to the shareholder without any economic difference to any party -- except for the fee paid to the tax advisor.

Recommendation: The Group recommends that to the extent an S corporation shareholder personally guarantees indebtedness of the S corporation, the shareholder should be permitted to reflect the personal guarantee as part of his basis in the entity for loss deduction purposes.

LEGISLATIVE LANGUAGE: ABA proposal to amend §§ 1366(d)(2), (d)(4), and 1368(f). But note this does not reflect last week's discussion regarding single guarantor/single note safe harbor guarantee.

<u>SECTION 1366</u>:

[Sec. 1366(d)]

(d) SPECIAL RULES FOR LOSSES AND DEDUCTIONS.--

(1) CANNOT EXCEED SHAREHOLDER'S BASIS IN STOCK AND DEBT.--The aggregate amount of losses and deductions taken into account by a shareholder under subsection (a) for any taxable year shall not exceed the sum of --

(A) the adjusted basis of the shareholder's stock in the S corporation (determined with regard to paragraphs (1) and 2(A) of section 1367(a) for the taxable year), ~~and~~

(B) the shareholder's adjusted basis of any indebtedness of the S corporation to the shareholder (determined without regard to any adjustment under paragraph (2) of section 1367(b) for the taxable year)<u>, and</u>

<u>(C) the shareholder's guaranteed debt basis described in paragraph 4 of this section 1366(d)</u>.

* * * *

<u>(4) GUARANTEED DEBT BASIS.--A shareholder's guaranteed debt, basis shall equal the amount of the corporation's guaranteed debt, as defined in Subparagraph (a), for which the shareholder has provided a personal guarantee or is otherwise personally liable for repayment times a fraction, the numerator of which is the number of shares in the corporation owned by the shareholder, and the denominator of which is the number of shares in the corporation owned by all shareholders who have provided personal guarantees or who are personally liable for such debt</u>.

<u>(A) GUARANTEED DEBT.--The term "guaranteed debt" shall refer to any debt of the corporation to a lender who is not a related person with respect to either the corporation or any of its shareholders on account</u>

of which one or more shareholders have provided a personal guarantee or are otherwise personally liable for repayment of such debt.

(B) RELATED PERSON.--For purposes of subparagraph (A), a person (hereinafter in this paragraph referred to as the "Related Person") is related to the corporation or any of its shareholders if the Related Person bears a relationship to the corporation or any of its shareholders specified in section 267(b) or section 707(b)(1). For purposes of applying sections 267(b) or 707(b)(1), "10%" shall be substituted for "50%" throughout each of those sections.

(C) EXCEPTION.--In no instance shall any shareholder be deemed to have personally guaranteed or to be personally liable for repayment of the corporation's debt to a lender in respect to any portion of any debt of the corporation as to which the shareholder is not personally liable, through guarantee or otherwise, or is protected against loss through nonrecourse financing a stop loss agreement, indemnification, or other similar arrangements. The relative financial resources of the shareholders shall not be considered in determining whether any shareholder is protected from loss.

In the case of any distribution made during any taxable year, the adjusted basis of stock shall be determined with regard to the adjustments provided in paragraph (1) of section 1367(a) for the taxable year.

* * * *

SECTION 1368:

[Sec. 1368(f)]

(f) RELIEF OF GUARANTEED DEBT DEEMED DISTRIBUTION.-- If a shareholder has guaranteed debt basis (as adjusted pursuant to section 1367(b)) and is relieved of all or a portion of the S corporation's guaranteed debt, as defined in subparagraph (A) of paragraph (4) of section 1366(d) due to indemnification, satisfaction or otherwise, then the portion of the guaranteed debt from which the shareholder is relieved shall be deemed to be a distribution by the S corporation during the tax year of the corporation during which the guarantee relief occurs and subject to the rules of subsection (a) to the extent the shareholder's pro rata share of the guaranteed debt, determined as described in section 1366(d)(4), exceeds the shareholder's guaranteed debt basis, as adjusted pursuant to subparagraphs (A) and (B) of paragraph (2) of section 1367(b).

PASSIVE INVESTMENT INCOME

1. Repeal excessive passive investment income as a termination event.

Current Law: Subchapter S contains two disincentives to discourage "incorporated pocketbooks" from operating as S corporations. First a corporate level tax is imposed on excess passive investment income. Second, S status is terminated if the corporation earns passive investment income that exceeds 25 percent of the entity's gross receipts for three consecutive taxable years and the entity has accumulated Subchapter C earnings and profits at the end of each of the three years.

Problem: While this result may be avoided through proper tax planning, many unadvised S corporations are caught unaware of these traps and lose their S status. The sanction of terminating S status when the entity has excessive passive income is unduly harsh.

> Example: Due to business fluctuations, the operating business of an S corporation declines over a period of several years. During the recession, a substantial portion of the corporation's income is derived from passive sources. Without proper advice, this corporation may not realize that its S status will terminate if this situation continues for three years.

Recommendation: To the extent Congressional intent is to limit the passive income of an S corporation, the Group believes this legislative intent is sufficiently served through the current procedures of imposing a corporate level tax on the S corporation's passive income. Therefore, the sanction of terminating the S election in the situation of excessive passive income should be repealed.

LEGISLATIVE LANGUAGE: ABA proposal to amend §1362(d)(3).

<u>SECTION 1362</u>:

[Sec. 1362(d)(3)]

To be deleted in its entirety.

2. Exclude trade or business income from the passive investment income definition.

Current Law: The definition of passive investment income for S corporation purposes includes the types of income earned by a personal holding company, and many traditional types of active trade or business income earned by an operating company.

Problem: By including certain types of active trade or business income in the passive investment income definition, many operating companies are precluded from making the S election.

Examples: Examples of such operating companies include certain rental real estate operators and certain corporations earning royalty income from the franchising of a product, process, or service.

Recommendation: The Group recommends that the income earned from the active conduct of a trade or business should not be included in the S corporation definition of passive income. It is recommended that a facts and circumstances test be adopted to determine what constitutes active as opposed to passive income. Examples of regulations that may be used in drafting a facts and circumstances test include Regulation sections 1.355-3(b) and 1.469-2T(c)(3)(i).

LEGISLATIVE LANGUAGE: No legislative language.

ELECTIONS

1. Permit the Secretary of Treasury to treat invalid elections as effective.

Current Law and Problem: The IRS has the authority to waive the effect of an inadvertent S corporation termination, but not the authority to waive the effect of an invalid election caused by an inadvertent failure to qualify as an S corporation.

Recommendation: The Group believes that the IRS should have the authority to waive an inadvertent invalid S corporation election for entities that have subsequently cured the defect. This new authority would be a broadening of the current IRS authority to waive the effect of an inadvertent S corporation termination. (H.R. 13 includes a measure to cure inadvertent S corporation elections.)

LEGISLATIVE LANGUAGE: H.R. 13 §§ 601 (a) and (b).

SEC. 601. AUTHORITY TO VALIDATE CERTAIN INVALID ELECTIONS.

(a) General Rule.—Subsection (f) of section 1362 (relating to inadvertent terminations is amended to read as follows:

"(f) Inadvertent Invalid Elections or Terminations.—If—

"(1) an election under subsection (a) by any corporation—

"(A) was not effective for the taxable year for which made (determined without regard to subsection (b)(2)) by reason of a failure to meet the requirements of section 1361(b) or to obtain shareholder consents, or

"(B) was terminated under paragraph (2) or (3) of subsection (d),

"(2) the Secretary determines that the circumstances resulting in such ineffectiveness or termination were inadvertent,

"(3) no later than a reasonable period of time after discovery of the circumstances resulting in such ineffectiveness or termination, steps were taken—

"(A) so that the corporation is a small business corporation, or

"(B) to acquire the required shareholder consents, and

"(4) the corporation, and each person who was a shareholder in the corporation at any time during the period specified pursuant to this subsection, agrees to make such adjustments (consistent with the treatment of the corporation as an S corporation) as may be required by the Secretary with respect to such period,

then, notwithstanding the circumstances resulting in such ineffectiveness or termination such corporation shall be treated as an S corporation during the period specified by the Secretary."

(b)Late Elections.—Subsection (b) of section 1362 is amended by adding at the end thereof the following new paragraph:

"(5) AUTHORITY TO TREAT LATE ELECTIONS AS TIMELY.—If—

"(A) an election under subsection (a) is made for any taxable year (determined without regard to paragraph (3)) after the date prescribed by this subsection for making such election for such taxable year, and

"(B) the Secretary determines that there was reasonable cause for the failure to timely make such election,

the Secretary may treat such election as timely made for such taxable year (and paragraph (3)) shall not apply."

2. Provide for automatic waiver of certain inadvertent terminations.

Current Law: The IRS has the authority to waive the effect of an inadvertent S corporation termination and *may* have authority to *automatically* waive such effect. A high percentage of private letter ruling requests on S corporations deal with the issue of inadvertent terminations.

Problem: For many taxpayers, obtaining a waiver of their terminated S status can result in costly professional fees. Also, valuable time on the part of IRS personnel and tax professionals is lost on processing routine taxpayer waiver requests.

Recommendation: The Group recommends that an automatic waiver procedure be authorized by Congress so that an entity would not lose its S corporation status due to a terminating event of a "ministerial" nature. An example of such an event is when a beneficiary fails to make a qualified subchapter S trust election.

LEGISLATIVE LANGUAGE: No Legislative language.

FRINGE BENEFITS

1. Place S corporation shareholders in the same position as owners of regular corporations with respect to fringe benefits.

Current Law: Unlike a C corporation, an S corporation is not permitted to provide shareholder-employees with certain tax-favored fringe benefits. Instead, the S corporation is treated as a partnership and 2 percent shareholders are treated as partners for fringe benefits purposes. All other shareholder-employees of the S corporation are treated like employees of a regular corporation with respect to fringe benefits.

Problem: S corporations operate at a disadvantage to C corporations with respect to fringe benefits paid to owner/employees. For owners of small businesses this is especially onerous because their fringe benefits are a greater portion of their overall compensation. Furthermore, owners of S corporations (like owners of partnerships and C corporations) are already governed by extensive antidiscrimination rules which makes section 1372 treatment unnecessary.

> Example: All the employees of a small retail store including the owners receive medical and group-term life insurance coverage. As a C corporation, these benefits are tax-free to all employees including the owners. However, if this corporation elects S status, the benefits will be taxable to the owners.

Recommendation: The Group recommends that all S corporation employees be eligible for tax-favored fringe benefits, which would ensure consistent treatment with the employees of a C corporation.

LEGISLATIVE LANGUAGE: No legislative language. [This proposal, if enacted would repeal section 1372 in its entirety.]

2. Repeal restrictions on qualified plan loans made to S corporation shareholders.

Current Law: A loan by a corporation's qualified retirement plan to a "disqualified person" is a prohibited transaction, subjecting the borrower to a penalty tax. For C corporations, a disqualified person includes any shareholder who owns ten percent or more of the corporation's stock. For an S corporation, however, any shareholder who owns *five percent* or more of the corporation's stock is a disqualified person.

Problem: When a C corporation makes an S election, any shareholder who owns between five and ten percent of the qualified retirement plan sponsored by the corporation must repay the loan before the effective date of the S election or face an automatic penalty tax. As a practical matter, very few people are aware that the restrictions on loans from qualified retirement plans are more stringent for an S corporation than for a C corporation. Consequently, five-to-ten-percent shareholders of a C corporation that elects S status may inadvertently find themselves subject to a penalty tax for failing to repay loans from qualified plans before the effective date of the S election.

> Example: A small software development company operates as a C corporation and maintains a qualified pension plan for its employees. An employee, who also owns 6 percent of the corporation's stock, borrows $10,000 from the plan to pay for a family medical emergency. The corporation elects to be an S corporation . The borrower/shareholder is unaware of the more restrictive limitation on plan loans to S corporation shareholder/employees and fails to fully repay the loan before the S election takes effect. He becomes subject to the automatic penalty.

Recommendation: The current more restrictive limitation on S corporation shareholders should be repealed. The definition of a "disqualified person", as including a ten-percent or greater shareholder, should apply uniformly to both C corporations and S corporations.

LEGISLATIVE LANGUAGE: Section 4975(d) would be amended by deleting from the last sentence of the flush language ". . . a shareholder-employee (as defined in section 1379, as in effect on the day before the date of the enactment of the Subchapter S Revision Act of 1982), . . .".

TECHNICAL PROPOSALS

1. Treat losses on liquidation of S corporations as ordinary to the extent the loss created by ordinary income passthrough triggered the liquidation.

Current Law: If an S corporation sells an appreciated asset or distributes it to shareholders, the appreciation in value of the asset is generally taxed once -- at the shareholder level. The gain recognized in such dispositions can be characterized either as capital gain or ordinary income, depending on the asset being sold or distributed. Any recognized gain or income increases the basis of S corporation shareholders in their stock. If the S corporation liquidates, any loss on liquidation will generally be a capital loss, even if, in the process of liquidation, ordinary income is recognized on assets sold or distributed. In other words, a shareholder can receive a flowthrough of ordinary income and resulting increase in basis as a result of disposition of assets in liquidation. But any loss on the liquidation will generally be capital loss, even if the basis was created by a transaction resulting in ordinary income.

Recommendation: The Group recommends that the loss recognized by a shareholder on the complete liquidation of an S corporation be treated as ordinary rather than capital to the extent the shareholder's basis in the S corporation stock is attributable to ordinary income, that was recognized as a result of the liquidation.

LEGISLATIVE LANGUAGE: ABA proposal to amend § 331(c).

SECTION 331:

Section 331 would be amended by adding the following as section 331(c) and redesignating former section 331(c) as section 331(d):

[Sec. 331(c)]

(c) LIQUIDATIONS OF S CORPORATION. -

(1) That portion of any loss recognized by a shareholder of an S corporation (as defined in section 1361(a)(1)) on amounts received by such shareholder in a distribution in complete liquidation of such S corporation equal to the ordinary income basis of stock of such S corporation in the hands of such shareholder shall not be treated as a loss from the sale or exchange of a capital asset but shall be treated as an ordinary loss.

(2) For purposes of this subsection, "ordinary income basis" of stock of an S corporation in the hands of a shareholders of such S corporation means that portion of such shareholder's basis in such stock equal to the aggregate increases in such basis under section 1367(a)(1] resulting from such shareholder's pro rata share of ordinary income of such S corporation, determined under section 1366.

2. **Allow a carryover of disallowed losses and deductions under section 465 to the post-termination transition period.**

Current Law: Losses of S corporation shareholders suspended by the subchapter S basis rules, may be recognized after the S election terminates and during the post-termination transition period if basis in the S corporation is generated during such period. S corporation losses may also be suspended under the at-risk rules. S corporations and their shareholders are treated in the same fashion as partners in partnerships under the at-risk rules. However, losses suspended through the application of the at-risk rules are *not* carried over to the post-termination transition period for the (former S corporation) entity.

Problem: The post-termination transition period rule allows a last-chance opportunity for S corporation shareholders to establish basis in the corporation and thus use losses that had passed through to them in previous years but that were nondeductible because of a lack of basis at that time. However, in some cases, S corporation shareholders had enough basis to deduct losses, but the losses were suspended under the at-risk rules for which there is no post-terminations transition period opportunity. To provide a last chance opportunity for these losses, it is appropriate to extend current law treatment of losses suspended because of insufficient basis to losses suspended under the at-risk rules.

Recommendation: Losses suspended in the application of the at-risk rules should be permitted to be carried over to the post-termination transition period.

LEGISLATIVE LANGUAGE: No legislative language.

3. **Expand the period of post-death S qualification for certain trusts.**

Current Law: A testamentary trust is permitted to be a shareholder of an S corporation for a period not to exceed 60 days following the death of a deceased S corporation shareholder. There is also a similar 2 year rule for grantor trusts and deemed grantor trusts. After the 60 day period, the trust must transfer ownership of the shares to an eligible S corporation shareholder or (if qualified) become a Qualified Subchapter S Trust. There is a two-year rule for those trusts with corpus included in grantor's estate.

Problem: The requirement that the trust transfer ownership of its S corporation shares within the 60-day period is a significant compliance and administrative burden for many taxpayers. The trustee may be unaware of the need to transfer the S corporation stock until advised to do so by a tax advisor who is involved in the administration of the decedent's estate. Often, this may not occur until more than sixty days following the decedent's death.

Example: The owner of a 20% interest in the stock of an S corporation that operates a farm equipment dealership provided in her will that on her death her stock would pass to a testamentary trust. A family member was named the trustee. The shareholder died on April 15, 1992. Not until February 1993, when family members consulted a tax advisor about preparing 1992 tax returns for the decedent, her estate and the trust did the trustee discover that the S corporation stock should have been transferred out of the trust within 60 days after the shareholder's death. As a result, the corporation's S election terminated on the sixty-first day.

Recommendation: The period of time that the trust may own the S corporation stock be extended to two years. By enacting a two-year period, Congress would be taking positive steps to relieve compliance and inadvertent termination problems.

LEGISLATIVE LANGUAGE: ABA proposal to amend § 1361(c)(2)(a)(ii) and (iii), with ABA's six-month period changed to 2 years plus deletion of the last sentence of (ii). The following language reflects these alterations.

SECTION 1361:

[Sec. 1361(c)(2)]

Section 1361(c)(2)(a)--

(ii) A trust which was described in clause (i) immediately before the death of the deemed owner and which continues in existence after such death, but only for the ~~60-day~~ two-year period on the day of the deemed owner's death. ~~If a trust is described in the preceding sentence and if the entire corpus of the trust is includible in the gross estate of the deemed owner, the preceding sentence, shall be applied by substituting '2 year period for '60 day six-month period'.~~

(iii) A trust with respect to stock transferred to it pursuant to the terms of a will, but only for the ~~60-day~~ two-year period beginning on the day on which such stock is transferred to it.

4. Modify order of adjustments to Accumulated Adjustments Account (AAA) and stock basis.

Current Law: Adjustments are made to the basis of an S corporation shareholder's stock in the sequence of income first, losses second, and distributions third. On the other hand, partnership basis is adjusted first by income, second by distributions, and third by losses.

Recommendation: The Group believes that the subchapter K rules involving the ordering of adjustments to basis should also apply in determining the basis of S corporation stock and the S corporation AAA. Thus, for purposes of subchapter S, distributions under this proposal would be taken into account before losses. (This proposal was included as a measure in H.R. 13.)

LEGISLATIVE LANGUAGE: H.R. 13 § 602.

SEC. 602. TREATMENT OF DISTRIBUTIONS DURING LOSS YEARS.

(a) Adjustments For Distributions Taken Into Account Before Losses.—

(1) Subparagraph (A) of section 1368(d)(1) is amended by striking "paragraph (1)" and inserting "paragraphs (1) and (2)(A)".

(2) Subsection (d) of section 1368 is amended by adding at the end thereof the following new sentence:

"In the case of any distribution made during any taxable year, the adjusted basis of the stock shall be determined with regard to the adjustments provided in paragraph (1) of section 1367(a) for the taxable year."

(b)Accumulated Adjustments Account.—Paragraph (1) of section 1368(e) (relating to accumulated adjustments account) is amended by adding at the end thereof the following new subparagraph:

"(C) NET LOSS FOR YEAR DISREGARDED.—

"(i) In General.—In applying this section to distributions made during any taxable year, the amount in the accumulated adjustments account as of the close of such taxable year shall be determined without regard to any net negative adjustment for such taxable year.

"(ii) Net Negative Adjustment.—For purposes of clause (i), the term 'net negative adjustment' means, with respect to any taxable year, the excess (if any) of—

"(I) the reductions in the account for the taxable year (other than for distributions), over

"(II) the increases in such account for such taxable year."

(c) Conforming Amendments.—Subparagraph (A) of section 1368(e)(1) is amended—

(1) by striking "as provided in subparagraph (B)" and inserting "as otherwise provided in this paragraph", and

(2) by striking "section 1367(b)(2)(A)" and inserting "section 1367(a)(2)".

5. Permit consent dividend for AAA by-pass election.

Current Law: Certain adverse consequences, including termination of the S election caused by excess passive investment income, can accrue to an S corporation which retains earnings and profits from the time it was a C corporation. C corporation earnings and profits can be purged from the corporation by making a shareholder distribution. Normally, such distributions are first made out of AAA. However, an election is available to by-pass AAA and make the distribution out of C corporation earnings and profits. Proposed regulations under section 1368, if finalized, would permit a corporation to elect consent dividend treatment to by-pass the AAA and distribute out its C corporation earnings and profits. (A consent dividend allows the corporation to make a deemed distribution followed by a deemed contribution.)

Problem: Without a consent dividend procedure, distributions must be made with cash or other assets. Frequently, sufficient cash or other assets are not available to make a distribution. A consent dividend procedure solves this problem. But some argue there may not be sufficient administrative authority to provide a consent dividend procedure in the regulations.

Recommendation: The Group supports the consent dividend treatment provision of the proposed regulations and therefore, recommends that this particular provision of the regulations be codified in addition to being included as part of final regulations.

LEGISLATIVE LANGUAGE: ABA proposal to amend §1368(e)(3)(C).

<u>SECTION 1368</u>:

[Sec. 1368 (e)]

(3) ELECTION TO DISTRIBUTE EARNINGS FIRST.--

<u>(C) CONSENT DIVIDEND.--Under regulations prescribed by the Secretary, and to the extent it has accumulated earnings and profits, a corporation may consent to treat as a distribution, subject to the election under this paragraph, the amount specified in such consent. The amount so specified shall be considered as distributed in money by the corporation to its shareholders on the last day of the taxable year of the corporation and as contributed to the capital of the corporation by the shareholders on such day</u>.

6. Permit subchapter C to apply to S corporations.

Current Law: An S corporation in its capacity as a shareholder of another corporation is treated as an individual for purposes of subchapter C. The IRS has taken the position that this prevents the tax-free liquidation of a C corporation into an S corporation under the rationale a C corporation cannot liquidate tax-free when owned by an individual.

Recommendation: The Group recommends repeal of the rule which treats an S corporation in its capacity as a shareholder of another corporation as an individual. Under this recommendation, the liquidation of a C corporation into an S corporation will be governed by the generally applicable subchapter C rules. (This proposal was included as a measure in H.R. 13.)

LEGISLATIVE LANGUAGE: H.R. 13 § 603(a).

> (a) Treatment of S Corporations Under Subchapter C.--Subsection (a) of section 1371 (relating to application of subchapter C rules) is amended to read as follows:
>
> "(a) Application of Subchapter C Rules.--Except as otherwise provided in this title, and except to the extent inconsistent with this subchapter, subchapter C shall apply to an S corporation and its shareholders."

7. Elimination of pre-1983 subchapter S earnings and profits.

Current Law: The accumulated earnings and profits of a corporation are not increased for any year in which an election to be treated as an S corporation is in effect. However, under the subchapter S rules in effect prior to 1983, a corporation electing S status for a taxable year increased its accumulated earnings and profits if its earnings and profits for the year exceeded both its taxable income for the year and its distributions out of that year's earnings and profits. The Subchapter S Revision Act of 1982 repealed this rule for earnings attributable to taxable years beginning after 1982 but did not do so for previously accumulated S corporation earnings and profits.

Recommendation: The Group recommends that a corporation's accumulated earnings and profits be solely attributable to taxable years for which an S election was not in effect. This recommendation involves the elimination of S corporation earnings and profits attributable to periods preceding the effective date of the Subchapter S Revision Act of 1982. (This proposal was included as a measure in H.R. 13.)

LEGISLATIVE LANGUAGE: H.R. 13 § 603(c).

(c) Elimination of Pre-1983 Earnings and Profits.—

(1) In general.—If—

(A) a corporation was an electing small business corporation under subchapter S of chapter 1 of the Internal Revenue Code of 1986 for any taxable year beginning before January 1, 1983, and

(B) such corporation is an S corporation under subchapter S of chapter 1 of such Code for its first taxable year beginning after December 31, 1991,

the amount of such corporation's accumulated earnings and profits (as of the beginning of such first taxable year) shall be reduced by an amount equal to the portion (if any) of such accumulated earnings and profits which were accumulated in any taxable year beginning before January 1, 1983, for which such corporation was an electing small business corporation under such subchapter S.

(2) Conforming Amendments.—

(A) Paragraph (3) of section 1362(d) is amended—

(i) by striking "subchapter C" in the paragraph heading and inserting "accumulated",

(ii) by striking "subchapter C" in subparagraph (A)(i)(I) and inserting "accumulated", and

(iii) by striking subparagraph (B) and redesignating the following subparagraph accordingly.

(B)(i) Subsection (a) of section 1375 is amended by striking "subchapter C" in paragraph (1) and inserting "accumulated".

(ii) Paragraph (3) is section 1375(b) is amended to read as follows:

"(3) PASSIVE INVESTMENT INCOME, ETC.—The terms 'passive investment income' and 'gross receipts' have the same respective meanings as when used in paragraph (3) of section 1362(d)."

(iii) The table of sections for part III of subchapter S of chapter 1 is amended by striking "subchapter C" in the item relating to section 1375 and inserting "accumulated".

(C) Clause (i) of section 1042(c)(4)(A is amended by striking 'section 1362(d)(3)(D)' and inserting 'section 1362(d)(3)(C)'.

8. Simplify the procedures for electing to close the books on the termination of a shareholder's interest.

Current Law: A corporation may elect to close its books at the date of complete termination of a shareholder's interest. All shareholders (including persons who were taxpayers at any time during the year) must give their consent to this election. This requirement imposes compliance burdens in the preparation and filing of timely corporate tax returns. According to the holding in an IRS private letter ruling, even if a corporation does not have the consensus of unaffected shareholders, it still may be in "substantial compliance" with the tax law when the allocations were prepared correctly.

Problem: Under current law, all shareholders of the corporation must consent to this election, including those that are unaffected. The necessity of obtaining the signatures of these unaffected shareholders imposes an unreasonable administrative burden, especially when the corporation is owned by multiple shareholders. Rather, the election should only be made by those affected shareholders, that is, those who were involved in a stock transaction during the year.

> Example: A small manufacturing business is owned by 24 shareholders. During the year, one of the shareholders sells her stock to an outsider. Because income is not earned ratably throughout the year, the parties decide that they wish to close the books at the date of sale, rather than allocate income as if it were earned ratably throughout the year. This election only acts to allocate income between the buyer and seller. It has no impact on the other 23 shareholders. Under current law, this consent must be obtained from all 24 shareholders no matter how small their stockholdings. This can unfairly hold the election hostage to shareholders who are unaffected by the election.

Recommendation: Instead of having to obtain the consent of all shareholders, the Group recommends that the closing of a corporation's books be permitted if both the affected shareholders and corporation consent.

LEGISLATIVE LANGUAGE: ABA proposal to amend § 1377(a)(2). [Shaded language indicates a change to the ABA draft needed to conform it to the Working Groups' proposal.]

SECTION 1377:

[Sec. 1377(a)]

(a) PRO RATA SHARE.--For purposes of this subchapter--

* * * *

(2) ELECTION TO TERMINATE YEAR.--

(A) IN GENERAL.--Under regulations prescribed by the Secretary, if any shareholder terminates his interest in the corporation during the taxable year and all ~~persons who are shareholders during the taxable year~~ affected shareholders and the corporation agree to the application of this paragraph, paragraph (1) shall be applied to the affected shareholders as if the taxable year consisted of 2 taxable years the first of which ends on the date of the termination.

(B) AFFECTED SHAREHOLDERS.--For purposes of subparagraph (A), the term 'affected shareholders' means the shareholder whose interest is terminated and all shareholders to whom he has transferred shares during the taxable year. If he has transferred shares to the corporation, 'affected shareholders' shall include all persons who are shareholders during the taxable year.

9. Expand the post-termination transition period.

Current Law: If an entity loses its S corporation status, it may distribute cash to shareholders during the post-termination transition period. The distribution is then applied against the adjusted basis of the stock. The shareholder receives the cash tax free to the extent the amount distributed does not exceed the Accumulated Adjustments Account (AAA). If there is excess, it is treated as capital gain. Also, the AAA ceases to exist for tax purposes at the end of the post-termination transition period. Distributions made after the post-termination transition period are taxed under the regular Subchapter C provisions.

Problem: Because of the large number of occurrences that can terminate a corporation's S election, an S corporation and its shareholders may be unaware of a termination until an IRS examination in a subsequent year brings the facts to light. In such situations where inadvertent termination relief may not be available, the period within which to make post-termination distributions may already have elapsed.

> Example: A shareholder of an S corporation irrevocably transferred stock to a trust that he believed in good faith to be an eligible S corporation shareholder. Two years later, an IRS examination determined that the trust was not eligible. Under the terms of the trust agreement, the stock cannot be transferred out of the trust. Accordingly, inadvertent termination relief is unavailable. Since the post-termination transition period has elapsed, the corporation is unable to make a tax-free distribution of its AAA.

Recommendation: The group recommends a broadening of the definition of post-termination transition period with respect to the 120 day period following a determination that the corporation's election had terminated for a previous taxable year.

LEGISLATIVE LANGUAGE: ABA proposal to amend § 1377(b)(1)(C).

SECTION 1377:

[Sec. 1377(b)]

(b) POST-TERMINATION TRANSITION PERIOD.--

(1) IN GENERAL.--For purposes of this subchapter, the term 'post-termination transition period' means--

(A) the period beginning on the day after the last day of the corporation's last taxable year as an S corporation and ending on the later of--

(i) the day which is 1 year after such last day, or

(ii) the due date for filing the return for such last year as an S corporation (including extensions), ~~and~~

(B) the 120-day period beginning on the date of a determination that the corporation's election under section 1362(a) had terminated for a previous taxable year, and

(C) the 120-day period beginning on the date of a determination (following the termination of the corporation's election) that adjusts an item of income (other than tax-exempt income), loss or deduction arising during the S period, but only if the determination arises in a corporate-level audit proceeding under sections 6241 through 6245 or in an audit proceeding with respect to a person who was the sole shareholder of the corporation at all times during each taxable year of the S period for which such adjustment has been made.

(2) DETERMINATION DEFINED.--For purposes, of paragraph (1), the term determination means--

(A) a determination as defined in section 1313(a).

~~(A)~~ (B) a court decision which becomes final,

~~(B)~~ (C) a closing agreement, or

~~(C)~~ (D) an agreement between the corporation and the Secretary that the corporation failed to qualify as an S corporation.